EXHIBIT NO. ______ (DEG-1TC)
DOCKET NO.____________
2001 PSE RATE CASE
WITNESS: DONALD E. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

DIRECT TESTIMONY OF DONALD E. GAINES
ON BEHALF OF PUGET SOUND ENERGY, INC.

NOVEMBER 26, 2001

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PUGET SOUND ENERGY, INC.
DIRECT TESTIMONY OF DONALD E. GAINES

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I. INTRODUCTION AND BACKGROUND

5
6 **Q. Please state your name, business address, and position with Puget Sound Energy, Inc.**

7 A. My name is Donald E. Gaines. My business address is P.O. Box 97034 OBC-15,
8 Bellevue, WA 98009-9734. I am Vice President & Treasurer at Puget Sound Energy,
9 Inc. ("PSE" or "the Company" hereinafter).

10
11 **Q. Have you prepared an exhibit describing your education and professional qualifications?**

12 A. Yes, I have. It is Exhibit DEG-2.

13 **Q. What are your duties as Vice President & Treasurer?**

14 A. I have overall responsibility for investing and raising capital in the financial markets.
15 I am also responsible for maintaining relations with credit rating agencies, financial
16 analysts and commercial and investment banks. In addition, I oversee the Company's
17 forecasting, analytical, performance analysis and budgeting activities.

18 **Q. What is the purpose of and the primary conclusions of your testimony?**

19 A. The purpose and primary conclusions of my testimony are summarized as follows:

20 - The Company needs and accesses the capital markets on a daily basis. In order to
21 meet these financial needs, PSE must have ongoing access to capital markets on
22 reasonable terms. However, the Company's ongoing access to capital has been
23 jeopardized and the cost of available capital is excessive. This is due to the
24 under-recovery of power costs (i.e., an under-recovery of approximately $625,000
25 per day) and the lack of a mechanism to timely recover these costs.

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1 • The Company is seeking to reestablish the financial profile that supports an "A" bond rating. An "A" rating provides an optimal balance of cost (economy) and risk (safety), and provides customers with a critical margin of safety during periods of industry change and uncertain conditions. However, due to the lack of a timely power cost recovery mechanism and the Company's current eroding financial position, S&P has twice downgraded the Company's credit ratings and Moody's has placed the Company's ratings under review for possible downgrade. The Company now faces the real risk of falling off the precipice of investment grade ratings, and the corresponding risk with respect to access to capital markets.

- The Company is requesting a capital structure that builds equity, thereby maintaining the appropriate balance of safety and economy. The Company's proposed capital structure includes an adjustment of $XXXXX million (in lieu of an attrition adjustment to revenue requirements) to increase earnings capacity. The Company will be able to achieve its proposed capital structure (less the amount of the proposed adjustment) by the end of the rate year by issuing equity.
- The total cost of debt is 7.40%. The cost of trust preferred is 8.58%. The cost of preferred stock is 7.78%.
- The total cost of equity is 14%, based upon Dr. Hadaway's recommended 13.5% cost of equity and a 50 basis point incentive adjustment for efficient and innovative operations.
- The requested overall rate of return for the Company is 10.47%.

II. THE COMPANY'S FINANCING NEEDS

Q. Please describe PSE's financial needs?

A. PSE incurs construction and operating costs necessary to provide safe and reliable service to its customers. These costs are presented for the test year in the testimony

1 of Karl R. Karzmar. As discussed in the testimony of William A. Gaines,
2 extraordinary circumstances attributable to volatility in the wholesale energy supply
3 markets have caused the Company's power costs to significantly increase. These
4 costs fall outside of the test year, and therefore are not captured in the revenue
5 requirements presented in this case.

6 Further, under its current rate structure, the Company is not fully recovering these
7 power costs, and has projected a shortfall of $XXX million between September 1,
8 2001 and the beginning of the rate year. This under-recovery is a short fall of
9 approximately $625,000 per day. As a result, PSE's access to needed capital is in
10 jeopardy, and the cost of available capital is excessive. This under-recovery will
11 produce financial results that fall significantly below PSE's authorized rate of return.

12 **Q. How does PSE typically meet these financing needs?**

13 A. In general, PSE obtains the money it needs through charges collected from customers
14 through Commission-approved rates. To the extent cash flow from customer bills is
15 insufficient to meet the Company's financial needs, PSE acquires funds from capital
16 markets. Historically, PSE has been, and is likely to remain, a "net borrower." This
17 means that the charges collected from customers are typically insufficient to meet all
18 of the Company's cash needs. When cash flows fall short of needs, the Company
19 must borrow. As a result, "financing" is not a periodic need. In fact, the Company
20 needs and accesses the capital markets on a daily basis. In order to meet the financial
21 needs discussed above, PSE must have ongoing access to capital markets on
22 reasonable terms.

23 **Q. What do you mean by "reasonable terms"?**

24 A. The Company is seeking to reestablish and maintain a financial structure that supports
25 an "A" bond rating. This, among other factors, will allow the Company to raise debt
26 capital at investment grade costs under most circumstances. "Reasonable terms"

1 means a cost of debt that is consistent with an investment grade credit rating, without
2 a penalty premium attributable to an unacceptable risk profile. Additionally,
3 "reasonable terms" means that the Company must be able to raise equity capital at a
4 stock price that is not artificially depressed by the current inability to fully recover
5 costs, uncertainty as to future cost recovery, and to maintain an appropriate level of
6 earnings.

7 **Q. What costs are currently associated with accessing capital markets?**

8 A. Currently, the Company's cost of debt as reflected in current spreads over Treasury
9 securities for 10-year debt is 250 basis points, which is 60 basis points higher than the
10 current 190 basis point spread for similarly rated utility debt. The cost level indicated
11 by these spreads is excessive. These are the very type of penalty premiums that, as
12 noted in the testimony of Howard Hiller, constitute unreasonable debt costs. It is also
13 unreasonably high when compared to the current average spread of 150 basis points
14 for "A" rated utility debt.

15 Similarly, the Company's cost of equity as reflected in current yields and growth rates
16 is 13.5% as described by Dr. Hadaway. This reflects the Company's current
17 diminished stock price and resulting high dividend yield.

18 **Q. What factors impact PSE's ability to access capital and the cost of capital?**

19 A. Investors in the debt and equity capital markets demand returns commensurate with
20 the risk of their investment. These elements of risk are not unique to the Company.
21 In general, as in other businesses, there are two types of risk facing the Company; (1)
22 *business risk*, or the riskiness of PSE's operations and its operating environment, and
23 (2) *financial risk*, the additional risk placed on common stockholders resulting from
24 the use of debt. These two types of risk can be balanced to present an acceptable risk
25 profile to investors, resulting in a reasonable overall cost of capital to customers.
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PSE currently has a significant business risk attributable to the volatility in the Company's power supply costs, which is a factor that it cannot control. This power cost risk, and the lack of timely recovery of these costs, is a key factor frustrating PSE's current ability to access capital on reasonable terms. This is why PSE needs a mechanism to recover these costs.

III. THE IMPORTANCE TO CUSTOMERS OF CREDIT RATINGS

Q. What are rating agencies and credit ratings?

A. There are independent agencies, called credit rating agencies, that assess the above-described risks for investors. The two most widely recognized rating agencies are Standard & Poor's (S&P) and Moody's Investors Service (Moody's). These rating agencies assign a credit rating to companies and their securities so investors can more easily understand the risks involved by investing in their debt and preferred stock.

Q. Why are credit ratings important to customers?

A. Credit ratings are important to customers because they are an independent assessment of risk. As a result, they are a major factor in determining the cost of capital to the Company and its customers. A declining credit rating, as experienced by the Company, increases the cost of capital and thereby increases the cost of service to customers.

Customers benefit when the appropriate risk profile, found by managing business risk with the appropriate degree of debt leverage, supports a credit rating that allows the Company to access capital at a reasonable cost. Because credit ratings take into consideration these risk elements and have such a dramatic impact on the cost of capital, they are of importance to customers.

Q. Please summarize the factors credit rating agencies examine when determining credit ratings.

A. Included as pages 1 through 19 in Exhibit DEG-3 is a copy of S&P's "Rating Methodology." Also included, as pages 20 through 27 is a description of Moody's ratings process. To summarize, S&P examines:

Corporate Credit Analysis Factors

Business Risk	Financial Risk
Industry Characteristics	Financial Characteristics
Competitive Position	Financial Policy
(e.g.) Marketing	Profitability
(e.g.) Technology	Capital Structure
(e.g.) Efficiency	Cash Flow Protection
(e.g.) Regulation	Financial Flexibility

Specifically for companies like PSE, S&P also examines regulation, markets, operations and competitiveness. In the area of "regulation", S&P assesses the following:

Electric T&D Company Rating Factors Related to "Regulation"

- The nature of the rate-making structure, e.g., performance-based vs. cost-of-service
- Authorized return on equity
- Timely and consistent rate treatment
- Status of restructuring, e.g., residual obligation to provide power, which entails the purchase of electricity for resale
- FERC's evolving rules for regional transmission organizations, independent system operators, and for-profit transmission companies
- Incentives to maintain existing delivery assets and invest in new assets
- Nature of distributor support that retains the status of provider of last resort

In examining the items listed above, there is no formula for combining assessments of these factors to arrive at a specific credit rating. The agency's collective experience

and expertise applied to a review of these factors results in a credit rating. As S&P states, "ratings represent an art as much as a science."

Q. Please summarize credit ratings.

A. The four highest credit rating categories, "AAA", "AA", "A" and "BBB", using S&P's nomenclature, are generally recognized as being investment grade. Ratings of "BB" and below are generally referred to as speculative grade (the term "junk bond" is merely a more irreverent expression for debt issued by firms of this speculative rating category). A more thorough description of these ratings categories can be found in Exhibit DEG-3.

Q. What credit rating does PSE need in order to attract capital on reasonable terms?

A. The Company is seeking to reestablish and maintain a financial structure that supports an "A" bond rating. PSE competes with other firms in the financial markets for investors' money. The Company must present a risk and return profile that will cause investors to invest in PSE rather than the other firms competing for investors' money.

Q. What is the credit rating of the State of Washington and publicly owned utilities in Washington?

A. The State of Washington and the majority of publicly owned utilities in the region maintain "A" or better credit ratings. The State of Washington taxes residents at levels that enables it to maintain a credit rating substantially higher than what the Company is requesting in this proceeding. The general obligation bonds issued by Washington State are rated as follows:

S&P rating	AA+
Moody's rating	Aa1

The major PUDs and municipal utilities located in Washington State with publicly traded bonds are allowed rates and capitalization that support credit ratings at or

above what the Company is requesting. Below is a list of S&P's credit ratings for these entities.

Seattle City Light	A+
Tacoma City Light	A+/stable
Snohomish County PUD	A+/stable
Douglas County PUD	AA-/stable
Franklin County PUD	A-/stable
Pacific County PUD	A-/stable

On October 22, 2001, S&P lowered the credit ratings of Seattle Municipal Light & Power from "AA-" to "A+". A Seattle Post Intelligencer newspaper article dated October 27, 2001 stated that City Light's ratings were cut after higher-than-expected power costs drained cash reserves. The article further mentions that City Light sidestepped more cash deficits by raising customer rates almost 58 percent this year and noted that additional rate increases in 2002 are likely if below-average rainfall reduces hydroelectric generation.

Q. Have public utility commissions recognized the value of a solid credit rating for investor-owned utilities?

A. Yes. The objective of maintaining a solid credit rating for investor owned utilities has long been accepted and approved by public utility commissions. In fact, this Commission has explicitly recognized the value of the Company maintaining an "A" bond rating in a decision involving amortization methods for accumulated deferred investment tax credits. In that order, the Commission stated:

> Puget has demonstrated that it will require additional earnings in the immediate future or risk losing the "A-" bond rating the company now enjoys, which could jeopardize its ability to attract capital on reasonable terms thus increasing costs for ratepayers.

The Commission further stated:

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> However, we wish to make it abundantly clear that the ITC treatment allowed by this order is justified only in view of Puget's financial condition and the threat of a lowered bond rating if relief is not forthcoming.

In the Matter of the Application of Puget Sound Power & Light Company, for Approval to Modify Amortization Methods for Accumulated Deferred Investment Tax Credits, Second Supplemental Order Granting Petition For Reconsideration, Cause No. U-86-115 (February, 1987), p.4 and p.5.

Q. Why is it important for PSE to maintain an "A" rating?

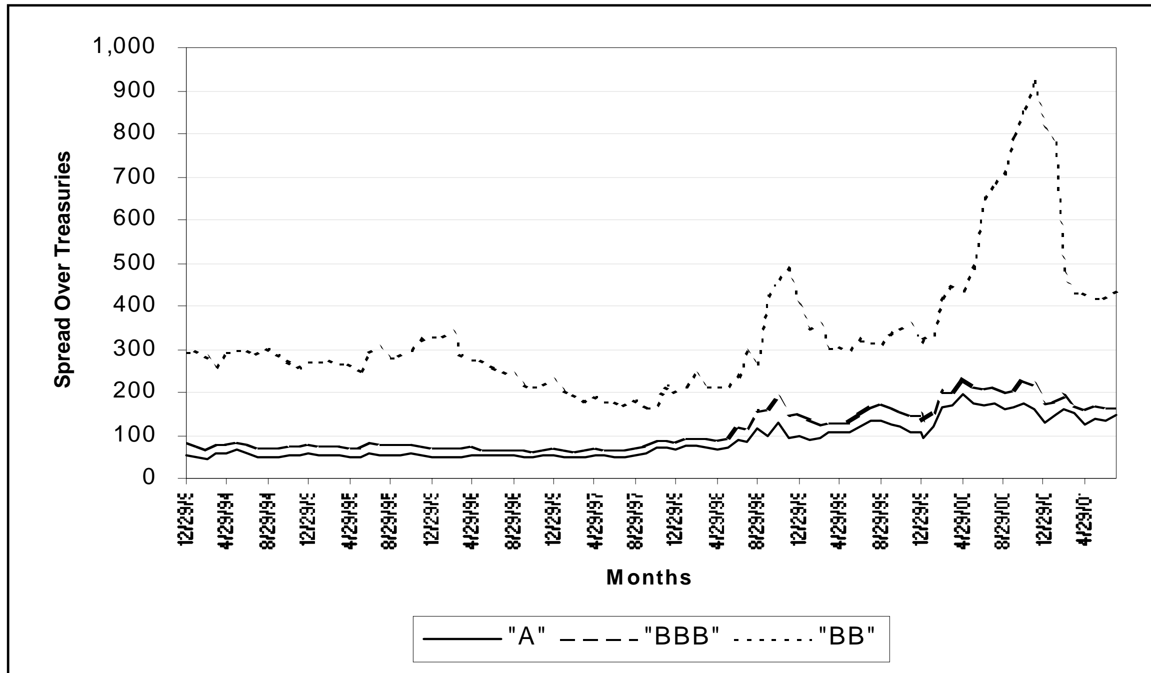
A. An "A" credit rating reflects a financial structure that provides an optimal balance of cost (economy) and risk (safety) while providing the Company with the financial flexibility needed to access the capital markets on reasonable terms in difficult times. An "A" rating is also important because it saves customers money and provides them with a margin of safety during periods of industry change and uncertain conditions. When negative developments occur, the reaction of rating agencies in downgrading a company can be dramatic and swift. The Company experienced this when it's debt was downgraded two notches by S&P, from "A-" to "BBB" in a matter of weeks in October 2001 due to the lack of timely power cost recovery mechanisms and the resulting erosion of the Company's financial position. Had the Company started with a corporate credit rating of just one notch lower, these actions would have resulted in the Company's credit being in the below investment grade or "junk" category. As it stands today, PSE is one notch away, and the preferred securities are now rated "junk."

Q. Does a "BBB" rating also provide an appropriate balance of economy and safety?

A. No. A "BBB" rating reflects increased risk levels that are only one step away from junk. It is dangerous to be teetering on the brink of non-investment grade rating. The increase in the cost of debt from an "A" rating to "junk" status ("BB") is always huge and can vary substantially over time. This can be seen in the following chart, which

contains historical credit spreads over Treasury securities from January 1993 to August 2001.

Credit Spreads Over Treasury Securities



The volatility in "BB" spreads is also dramatic. From the chart above, one can see the spread between "A" and "BBB" rated securities remains fairly constant and narrow. However, the spreads between these ratings and "BB" rated securities is wide and has varied substantially. When these spreads will contract or expand is unpredictable. Such wide spreads have a huge impact on borrowing costs.

Q. Is the stability of the Company's credit rating also important?

A. Yes. A strong credit rating should be maintained over time as the Company requires continuous access to capital markets. When a company faces financial difficulties that threaten its credit rating, typically the capital markets will react negatively before the credit rating agencies downgrade the credit rating. However, if a company subsequently takes steps to improve its financial position and its credit rating is

1 upgraded, the market will lag the upgrade – taking longer for the company to benefit
2 from the reduced capital costs associated with a better credit rating. It is by
3 maintaining a solid credit rating over time that a company maintains access to capital
4 on reasonable terms.

5 **Q. Please provide some quantitative examples of why it is important to maintain an**
6 **"A" credit rating.**

7 A. The following table shows average spread differential for certain bond ratings from
8 January 1993 through August 2001:

9 **Average Credit Spreads Over Treasury Securities**

Rating	Average Spread	Change from A Rating
A	0.87%	
BBB	1.14%	0.27%
BB	3.37%	2.50%

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11
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13 Using the average spreads above, the additional cost of dropping below investment
14 grade on a $200 million debt offering would be $5 million per year. The cost of
15 maintaining an "A" vs. a "BBB" rating is one tenth of that amount.
16 Equally as important, but far more extreme, is the impact on the value of all the debt
17 outstanding. The Company's approximately $2 billion of long-term debt outstanding
18 has a cost rate of 7.40% and an average remaining maturity of 13.6 years. The cost to
19 bondholders of a 250 basis point increase in yield drops the value of this debt by
20 approximately $365 million. Dramatic changes in the value of bondholders'
21 investment will cause them to demand compensation for being exposed to such
22 volatility. This is why it is important to maintain an "A" bond rating at all times, not
23 just when the Company is planning to issue securities. Maintaining the rating is also
24 an indication of management's commitment to credit quality – a commitment the
25 rating agencies look for when assessing a company's management.
26

In addition to spreads widening on long-term debt issues, upon a downgrade to below investment-grade status, spreads would also widen on commercial paper and other short-term borrowings. Credit sensitive commercial paper buyers likely will no longer be interested in lending to PSE. Like commercial paper, uncommitted borrowings are likely to become limited to an over-night basis or may become unavailable altogether. This happened earlier in 2001 when it became clear the California utilities would not be paying for their power purchases on time and again as a result of the recent S&P downgrades.

The Company's $375 million revolving line of credit contains pricing that is based on credit ratings. As the credit rating declines, the cost of borrowing increases. The recent drop in the Company's credit ratings increased the London Interbank Offering Rate ("LIBOR") margin in that agreement from 25 basis points to 30 basis points and the commitment fee from 8 basis points to 9 basis points. As a result, the annual cost of that agreement has risen by $187,500 assuming the line is fully used.

At lower bond ratings, bond insurance costs increase or such insurance may become unavailable altogether. The Company had been considering refinancing its pollution control bonds with similar securities of lower interest rates. The bond insurer AMBAC insures the existing bonds. Recent discussions with AMBAC indicated they would not be willing to insure PSE's bonds given its current credit ratings and regulatory climate. Investment bankers have told the Company that such bonds cannot be refinanced without the new bonds being insured – there simply is no market for them. As a result, the Company is no longer able to refinance those securities.

In addition to these impacts on the cost of debt, there are other costs of not maintaining an "A" rating. Many firms who currently do business with PSE will not do business with firms rated below investment grade (e.g. Citibank Bankers Leasing,

1 the company with whom PSE maintains a master operating lease agreement, will not
2 do business with firms rated below investment grade).

3 **Q. What are PSE's current credit ratings.**

4 A. The Company's current credit ratings are as follows:

5 **PSE's Credit Ratings**

	S&P	Moody's
Senior Secured Debt	BBB	Baa1
Issuer (Company) Rating	BBB-	Baa2
Senior Unsecured Debt	BB+	Baa2
Trust Preferred Rating	BB	Baa3
Preferred Stock Rating	BB	Ba1
Commercial Paper	A-3	Prime -2

6 7 8 9 10 11 12

13 These ratings reflect the fact that S&P has twice downgraded the Company's credit
14 ratings due to the lack of a timely power cost recovery mechanism and the Company's
15 current eroding financial position. Moody's has placed the Company's ratings under
16 review for possible downgrade. In their October 26 announcement, Moody's states:

17 > Although PSE's financial performance is showing the negative effects of the current mismatch between its existing electric rates and the net supply costs it is incurring, we believe that taking immediate action to downgrade the ratings in response to the recent orders would be premature. We choose instead to await further developments in the upcoming general rate filing. Moody's will continue to assess PSE's ability to achieve some initial financial relief in the form of an interim rate hike relatively early in the general rate case, or from other actions the state might take within the same near-term horizon.

18 19 20 21 22

23 Prior to these recent announcements, the Company's senior secured debt was rated
24 "A-" and "Baa1" by S&P and Moody's respectively. The Company's corporate credit
25 ratings were "BBB+" and "Baa2" and its commercial paper was rated "A-2" and
26 "Prime-2" by S&P and Moody's respectively.

Q. Assuming the Commission grants the rate relief requested in this proceeding, will the projected financial results support an "A" rating?

A. As noted above, credit rating agencies examine a number of qualitative and quantitative factors in determining a credit rating, and there is no formula for combining assessments of these factors to arrive at a specific credit rating. However, I believe that the combination of granting timely and appropriate interim relief, and in the general case, putting in place a stronger capital structure, the appropriate return on equity and regulatory mechanisms that reduce the Company's power cost risk will likely lead credit rating agencies to look more favorably on the Company's financial condition, and will support a solid investment-grade credit rating. Taken together, these factors will significantly improve the Company's risk profile and demonstrate a supportive regulatory climate that should move PSE well toward the goal of reclaiming an "A" rating.

IV. CAPITAL STRUCTURE

Q. What factors are typically considered in selecting the appropriate capital structure?

A Selecting the appropriate capital structure involves a balancing of risk and cost. In Puget Sound Power & Light Company's 1992 rate case, the Commission referred to this balance of economy and safety. The Commission said:

> The Commission determines an appropriate balance of debt and equity within the capital structure on the bases of economy and safety. Because the composite cost of debt is generally less than that of equity, overall capital costs can be expected to decrease as a greater portion of the capital structure is composed of debt. The economy of lower capital cost must be balanced against the safety of the capital structure.
>
> The concept of "safety" refers to the fact that the company has no legal obligation to pay a return to the holders of common stock. In dire financial circumstances, a company can reduce or suspend the payment of dividends to the owners of common stock without the legal consequences that would flow from a failure to pay interest on debt.

> In return, holders of common equity generally demand a greater return than do lenders who have a claim on the company's earnings.

Puget Sound Power & Light Company, Cause No. UE-921262 (1993).

As the Commission observed, a capital structure with a high equity component does not take advantage of lower cost tax-deductible debt, resulting in relatively high capital costs to customers. Incorporating too much debt leverage into the capital structure adds risk, and as the Commission observes, this can result in dire financial consequences. In such cases, the appropriate regulatory action (in the context of a general rate case) is to provide interim regulatory relief before a utility faces dire financial circumstances. This properly avoids the negative financial consequence of forcing a utility to reduce or suspend the payment of dividends, further deflating investor interest in equity, and thereby making it incredibly expensive (if not impossible) for the utility to issue additional equity and restore the appropriate balance of risk and cost.

Q. How has the Commission struck this balance in the past?

A. In its last general rate case, Puget Sound Power & Light Co. was authorized a capital structure of 45% equity. This was done in the context of the Company operating under a power cost tracker mechanism ("PRAM"). Similarly, in its last general rate case, Washington Natural Gas was authorized a capital structure of 44% equity and operated with a Purchased Gas Adjustment ("PGA") mechanism. These equity ratios are in line with the capital structures of the comparable companies used in Dr. Hadaway's analysis. As Dr. Hadaway testifies, the comparable companies have tracking mechanisms (or are presented with other circumstances) that effectively shield them from significant power cost risk. Their equity ratios on average are also consistent with the Company's current request.

Q. What is the Company's actual capital structure?

A. As of September 30, 2001, the Company's capital structure is as follows:

Capital Component	Percentage
Short-term Debt	7.1%
Long-term Debt	51.5%
Trust Preferred	7.1%
Preferred Stock	2.6%
Common Equity	31.7%
Total Capitalization	100.0%

Q. Does the Company's current capital structure appropriately balance the risks and costs of shareholder and debt funding?

A. No. Since the merger, the equity component of the Company's capital structure has eroded. The Company's ability to rebuild equity is hampered by its artificially depressed stock price and uncertainties surrounding the Company's ongoing financial condition, such as PSE's exposure to power cost risk of a magnitude equivalent to its annual earnings. It is important to resolve these uncertainties so that the value of the Company's equity can be restored, and the Company can issue equity at its restored value to reestablish its historic equity ratio.

Q. What is PSE's capital structure expected to be during the rate year?

A. Page 1 of Exhibit DEG-4C shows what PSE's capital structure that is expected to be towards the end of the rate year. PSE will achieve this capital structure as a result of debt maturities and retirements, retained earnings, additional equity issued to meet the

1 requirements of the dividend reinvestment plan, through sales of common stock and
2 an adjustment to the capital structure as discussed below.

3 **Q. What is the Company's plan to achieve the requested capital structure?**

4 A. The Company's proposed capital structure includes an adjustment of $XXXX million
5 (in lieu of an attrition adjustment to revenue requirements) to increase earnings
6 capacity. The Company will be able to achieve its proposed capital structure (less the
7 amount of the proposed adjustment) by the end of the rate year by issuing equity.
8 The Company's plan to issue equity includes public sales of common stock in
9 November 2002 of $XXX million and another $XXX million in April 2003. The
10 issues are timed to follow the completion of the general rate proceeding, to avoid
11 selling stock at an artificially depressed price before the results of the case are known
12 to the financial markets.

13 The adjustment to the proposed capital structure of $XXXXX million is made in lieu
14 of an attrition allowance to revenue requirements. This accounts for the financial
15 impact of extraordinary circumstances attributable to volatility in the wholesale
16 energy supply markets, which circumstances have caused the Company's net power
17 costs to significantly increase. These events, and the resulting costs, are described in
18 the testimony of William A. Gaines. These costs are not included in test year costs,
19 and are of such a magnitude that they are not offset to any significant degree by cost
20 savings in other areas, or by revenues.

21 Under these circumstances, PSE could seek an attrition adjustment to revenue
22 requirements. However, rather than seeking an attrition allowance to revenue
23 requirements, PSE has made a comparable adjustment to its proposed capital
24 structure. This also helps to reestablish the appropriate balance of debt and equity.
25 The resulting earnings capacity will allow the Company to prospectively reduce debt
26 and offset, over time, the adjustment to retained earnings with actual earnings.

1 Should, however, the Company be granted interim relief during the pendency of this
2 proceeding for some portion of these extraordinary costs, the adjustment to the capital
3 structure would be reduced similarly.

4 **Q. How does the capital structure the Company is requesting compare to the**
5 **companies included in Dr. Hadaway's comparable company analysis?**

6 A. Dr. Hadaway includes 23 companies in his comparable company analysis. As can be
7 seen in the table below, on average, these companies' capital structures compare
8 favorably to the capital structure the Company is requesting:

Capital Component	PSE Request	Dr. Hadaway's Comparable Companies
Debt	52.7%*	51.5%
Preferred Stock	2.3%	3.1%
Common Equity	45.0%	45.4%
Total	100.0%	100.0%

* For comparison purposes, the Company's trust preferred has been included with debt.

While very similar, it should be noted that the comparable companies have slightly more equity than PSE is requesting in this proceeding.

16 **Q. Are you proposing the same capital structure for gas and electric operations?**

17 A. Yes. Puget Sound Energy is an integrated gas and electric utility. The Company is
18 not run with separate electric and gas divisions. The capital acquired to finance the
19 Company is not split between gas and electric operations. The use of proceeds from
20 such financing is not tied to any one type of energy. As a result, a single capital
21 structure is appropriate.

22 **V. THE COST OF DEBT**

23 **Q. What has the Company done to reduce its debt cost since the last general rate**
24 **proceeding?**

25 A. The Company has taken several steps to reduce its cost of debt. First, when the
26 Company issues long-term debt, it almost exclusively issues debt secured by

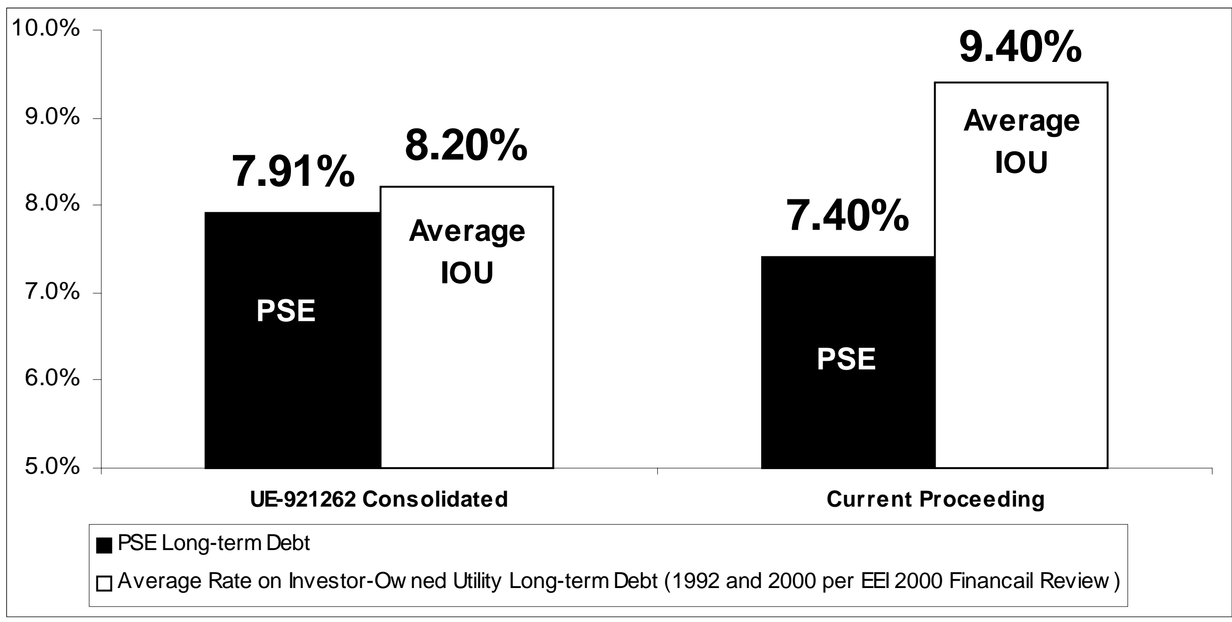
1 mortgages on its electric and gas properties. As a gas and electric distribution
2 business, the Company has plenty of property to use to as collateral to secure its debt.
3 Because of the collateral backing, secured debt is less expensive than unsecured debt.
4 In the debt capital markets, for a company like PSE that was split rated before the
5 recent downgrades, secured debt can typically be issued with a coupon rate that is 30
6 to 40 basis points less than unsecured debt of similar terms. That savings reduces the
7 cost of debt to PSE's customers.
8 The Company also looks to refinance its investments with less expensive debt when it
9 is able to do so. Although very little of the Company's debt is callable, there have
10 been instances where the Company was able to refinance debt at a savings.
11 In 1995 and again in 1997, the Company was able to refinance its investment in
12 customer owned conservation by securitizing the revenue streams customers would
13 pay for such investments. Once the Commission approved these revenue streams for
14 recovery under state law, the Company sold those streams to investors. With the
15 backing of state law and other features of the issues (such as a small amount of over-
16 collateralization and a provision for true-ups to the revenue streams), the revenue
17 streams were used to repay debt issued to investors at the highest of credit ratings.
18 This resulted in these investments being financed at much lower rates and creating a
19 savings to customers. The Company was credited as the first utility to securitize its
20 conservation investment and this structure was successfully used for other purposes in
21 other states and in foreign countries.
22 Another example of this was related to the Company's acquisition of the Encogen
23 generating facility. In acquiring that project, the Company assumed approximately
24 $109 million of Encogen project debt. The assumed debt contained interest rates
25 ranging from 8.64% to 13.03%. These rates were higher than what the Company
26 would pay for debt capital at the time and the project nature of the assumed debt

placed certain administrative requirements on the facility. These included insurance requirements and an annual project audit. Through negotiations with the lenders, the Company was able to pay off this expensive project debt with a portion of the proceeds of a $225 medium term note with a 7.96% coupon rate. The savings from this refinancing was approximately $1.9 million on a present value basis. The retirement of the project debt also removed the administrative requirements.

As a result of this and other activities, the Company's cost of debt has declined since the last time debt costs were recovered in a general rate proceeding. The cost of long-term debt has declined from 7.91% to 7.40%, a total reduction of 51 basis points. That reduction, when applied to the approximately $2 billion of long-term debt that will be outstanding on average during the rate year, represents a reduction in interest expense of approximately $10 million per year.

The following chart reflects the cost of debt and how it has changed since the Company's last general rate proceeding.

Cost of Long-term Debt



1 **Q.** **Would you summarize your calculation of the cost of long-term debt?**

2 A. The cost of long-term debt was calculated in similar manner to its calculation in prior
3 rate proceedings. Consideration was given as to whether or not the embedded rate at
4 June 30, 2001, was a reasonable measure of the cost of debt in light of the long-term
5 debt transactions expected to occur through September 30, 2003, the end of the rate
6 year. I believe, consistent with the past practices of this Commission, that
7 prospective debt costs should be considered.

8 To calculate the cost of long-term debt, the yield-to-maturity or cost rate of each debt
9 issue is calculated, using the issue date, maturity date, net proceeds to the Company
10 and coupon rate of that security. The proportional share that each issue's principal
11 amount represents of the total amount of long-term debt outstanding is then used to
12 weigh these cost rates.

13 These calculations can be found on pages 3 through 5 of Exhibit DEG-4C.

14 **Q.** **How did you treat the 1995 and 1997 conservation securitization debt?**

15 A. The conservation securitization debt has been included as part of the cost of long-
16 term debt. Likewise, the corresponding unamortized balances of these investments
17 have been included as part of rate base.

18 The Company acts as the servicer on these transactions. As a result, it includes the
19 unamortized balance of its investment in rate base and the related debt in its capital
20 structure. That results in the costs of those transactions being included in customer's
21 bills. The Company forwards to two separate trusts the revenue streams related to
22 these transactions as required and defined in the related rate schedules. The 1997
23 conservation securitization will mature and will no longer be outstanding before the
24 beginning of the rate year. As a result, only the 1995 transaction has been included in
25 the cost of debt and rate base.

26

Unlike a typical medium-term note which matures on a specific date, the conservation securities are similar to home mortgage debt in that a portion of the principal is paid with each monthly (or in the case of this transaction, quarterly) payment. As a result, I have calculated the internal rate of return for this security using the original balance and the actual and expected quarterly repayments. These calculations can be seen on page 6 of Exhibit DEG-4C.

Q. How did you treat new issues of long-term debt?

A. The Company is not planning to issue any additional long-term debt between the test year and the end of the rate year. As a result, there are no new issues to include.

Q. Are there any issues of long-term debt that will mature or retire between the test year and the end of the rate year?

A. Yes. The long-term debt maturities and retirements since the end of the test year are shown on page 5 of Exhibit DEG-4C.

Because these issues will not be in place during the rate year, they have been excluded from the calculation of the cost of long-term debt.

Q. What is the resulting cost of long-term debt?

A. The embedded cost of long-term debt is 7.40% as shown on line 41, page 5 of Exhibit DEG-4C.

Q. Would you summarize your calculation of the cost of short-term debt?

A. In the Company's last several general rate cases, the capital structure that the Commission approved included short-term debt as part of the debt component of capital structure. The level of short-term debt expected to be outstanding at the end of the rate year is $15 million. However, as a result of my capital structure attrition adjustment, the capital structure I am proposing for rate setting purposes includes no short-term debt. This is depicted on page 2 of Exhibit DEG-4C.

To calculate the cost of short-term debt during the rate year, the Company calculates the current spread between its short-term borrowing costs and LIBOR, then applies that spread to an estimate of LIBOR during the rate year. The expected cost of the Company's revolving credit agreement is also included in the cost of short-term debt. This calculation can be seen on page 11 of Exhibit DEG-4C.

The resulting cost of short-term debt is 6.25%.

Q. How did you determine the overall cost of debt as part of your rate of return calculation?

A. The total cost of debt is 7.40%, as shown on line 41, page 5 of Exhibit DEG-4C.

VI. THE COST OF TRUST PREFERRED

Q. Please describe trust preferred securities.

A. Trust preferred is a security that contains equity-like characteristics yet the cost is deductible for federal income tax purposes. On PSE's financial statements, these securities are called "corporation obligated, mandatorily redeemable preferred securities of subsidiary trust holding solely junior subordinated debentures of the corporation." Because that is a rather unwieldy name, the generic title "trust preferred" is often used to describe these securities.

In issuing trust preferred, the Company creates a trust that then issues preferred stock to investors. The trust then lends the proceeds from the sale of the preferred stock to the Company on terms (i.e. maturity, interest rate, etc.) that are identical to the terms of the preferred stock. Typically, these terms include a provision for interest on the loan, and dividends to investors, to be deferred under certain circumstances. Because the Company has borrowed the proceeds from the trust, the Internal Revenue Service allows the interest on the loan to be deductible for federal income tax purposes. Because the interest and dividends are deferrable, and because of the relatively long maturity (i.e. 30 or 40 years), the credit rating agencies consider the securities as

1 having certain equity-like characteristics. S&P, for example, considers the trust
2 preferred of the Company as being 40% equity and 60% debt.

3 **Q. How many trust preferred issues does the Company have outstanding?**

4 A. The Company has two trust preferred issues outstanding. These include a $100
5 million 8.231% series issued June 6, 1997 and maturing on June 1, 2027 and a
6 $200 million 8.40% series issued on May 24, 2001 and maturing on June 30, 2041.

7 **Q. How did you determine the costs of these two issues?**

8 A. The cost rates for these two issues were calculated in the same manner as the cost
9 rates for debt issues. The specific calculations of these costs can be seen on page 12
10 of Exhibit DEG-4C.

11 **Q. What is the resulting cost of trust preferred?**

12 A. The resulting cost of trust preferred is 8.58%.

13 **Q. How have you included the trust preferred in the capital structure?**

14 A. Being a separate type of security, I have included the trust preferred as a separate line
15 in the capital structure. Although trust preferred contains equity-like characteristics
16 (e.g. deferrable interest and dividends), the cost of these securities is deductible for
17 federal income tax purposes. Showing trust preferred as a separate line item
18 facilitates their proper treatment in the calculation of the revenue requirement.

19

20 **VII. THE COST OF PREFERRED STOCK**

21 **Q. Please review the Company's refinancing program with respect to preferred stock.**

22

23 A. Since the last general rate proceeding, the Company has redeemed several of its
24 higher cost preferred stock issues. Specifically, the Company has redeemed the 8.5%
25 series, the 8.0% series, the 7.875% series and its adjustable rate preferred stock. As a

26

1 result, there are four remaining series of preferred stock as shown on page 12 of
2 Exhibit DEG-4C.
3 **Q. Will you then proceed with your comments on the cost of preferred stock?**
4 A. The cost of preferred stock is calculated in the same manner as has been done in prior
5 rate proceedings. That is, the cost is calculated by weighting the cost rate of each
6 issue by the balance outstanding during the rate year. The cost of reacquired
7 preferred stock is also included. Page 12 of Exhibit DEG-4C shows the calculation of
8 the embedded cost of preferred stock. The resulting cost of preferred stock is 7.78%.

9 ## VIII. THE COST OF COMMON EQUITY

10 **Q. Have you prepared a study of the cost of common equity for PSE?**
11 A. No. I have relied on the study prepared by Dr. Hadaway.
12 **Q. Do you agree with his findings?**
13 A. Yes. Dr. Hadaway has used several different methods to determine the appropriate
14 cost of equity capital for PSE. His conclusion is that the fair cost is 13.5% if interim
15 rate relief is not granted or 11.5% if appropriate interim rate relief, which relief is
16 critical, is granted.
17 **Q. What equity cost rate are you using in determining the rate of return?**
18 A. In addition to Dr. Hadaway's recommended 13.5% cost of equity, I include a 50 basis
19 point incentive adjustment for efficient and innovative operations consistent with the
20 standard established for such adjustments in WUTC vs. Avista Corp., Docket No.
21 UE-991606, UE-991607 (September 29, 2000). Such an incentive adjustment is
22 appropriate upon a showing of truly extraordinary circumstances. The basis of this
23 adjustment is PSE's success in developing and implementing innovative management
24 tools and technologies, and in achieving significant efficiencies and cost savings as
25
26

1 described, in detail, in the testimony of John M. Shearman, Susan McLain and Penny
2 Gullekson. This adjustment is calculated on page 15 in Exhibit DEG-4C.
3 As described in Mr. Shearman's testimony, the Company is among the lowest-
4 cost utilities in the industry and has achieved savings since the merger far in excess of
5 those projected at the time of the merger or of those obtained as a result of other
6 mergers in the industry over the last decade. As shown in Mr. Shearman's exhibit
7 JMS-47, the savings achieved by the Company will produce significant value beyond
8 those projected. My 50 basis point adjustment to the cost of equity, reflects a sharing
9 of those extraordinary savings between the Company and its customers and is within
10 the range of equity returns described by Dr. Hadaway. This adjustment is analogous
11 to the recovery of the fair and equitable cost of research and development.
12 Such an adjustment provides a going-forward incentive for continued efficiency and
13 innovation, benefiting customers. Conversely, lack of such incentives encourages
14 mediocrity.

15 **IX. RATE OF RETURN**

16 **Q. Would you now discuss your recommended overall rate of return given the proposed capital structure?**

17 A. Yes. On page 1 of Exhibit DEG-4C the cost rate for each capital component is
18 applied to the recommended capital structure. Absent interim rate relief, the
19 Company requires a 14% cost of equity, as described above. Using that rate, the
20 overall rate of return for the Company is 10.47%.
21 The calculation of these amounts is shown below:
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23
24
25
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Component	Ratio	Cost Rate	Weighted Average
Debt	45.66%	7.40%	3.38%
Trust Preferred	7.08%	8.58%	0.61%
Preferred Stock	2.26%	7.78%	0.18%
Common Equity	45.00%	14.00%	6.30%
Total	**100.0%**		**10.47%**

However, were the Company granted appropriate interim relief, which relief is critical, then PSE's cost of equity would be 12% and the resulting overall rate of return would be 9.57%.

Q. Would you propose the same rate of return for gas and electric operations?

A. Yes. PSE is an integrated gas and electric company. As such, the capital structure and cost of capital are appropriate for the integrated company. In addition, the 13.5% cost of equity recommended by Dr. Hadaway was based on the Company's stock price without any distinction between gas and electric operations.

Q. Does that conclude your testimony?

A. Yes, it does.

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